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1ST QUARTER 2015

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Latest Transaction Multiples from Pratt's Stats

Private companies in the mining and finance/insurance/real estate industry groups have the highest values relative to their revenues, according to the latest quarterly *Pratt's Stats Private Deal Update* (available with a subscription to the *Pratt's Stats* deal database). These industry groups have a median selling price/revenue valuations multiple of 1.84 and 1.13, respectively. At the low end are firms in the retail (0.37) and construction (0.41) industries. The table below presents the total count of transactions in *Pratt's Stats* by major industry group as well as median valuation multiples. The data below include private companies purchased by public and private companies. There are now over 22,000 private-company transactions in the database.

SIC	Industry (transaction count)	MSP/Rev
0111-0971	Agric./Forestry/Fishing (531)	0.57
1011-1499	Mining (202)	1.84
1521-1799	Construction (802)	0.41
2011-3999	Manufacturing (3,786)	0.78
4011-4971	Transport./Public Util.(1,091)	0.81
5012-5199	Wholesale (1,210)	0.45
5211-5999	Retail (5,912)	0.37
6011-6799	Finance/Ins./Real Estate (883)	1.13
7011-9999	Services (7,781)	0.69
0139-9999	All Industries (22,198)	0.56

Happy New Year. We hope that you had a nice holiday season. In the 1st Quarter 2015 newsletter, you will find the following short articles:

- Latest Transaction Multiples from Pratt's Stats
- DLOM Bounces Back in Big NY Fair Value Case
- Cap Rates Down in Senior Healthcare Market
- 10 Reminders for a Successful Divorce Valuation
- Economic Update at a Glance

We hope that you enjoy the articles. Please feel free to call us if you need any assistance with valuation matters. Thank you, and we look forward to working with you in 2015.

DLOM Bounces Back in Big NY Fair Value Case

***Ferolito v. AriZona Beverages USA LLC,* 2014 N.Y. Misc. LEXIS 4709 (Oct. 14, 2014)**

Only a week after a New York trial court issued its contentious ruling that KO'd DLOM (Discounts for Lack of Marketability) in *Zelouf* (Zelouf v. Zelouf, 2014 N.Y. Misc. LEXIS 4341 (Oct. 6, 2014)), a different court pronounced on the issue in another pot-stirring fair value proceeding that featured an "extremely successful company," extremely contentious business partners, and extremely well-known valuators.

The successful company is AriZona (of iced tea fame), founded in 1992 by the plaintiff and the defendant and now the largest privately owned beverage company in the United States. Both partners were equal shareholders but after a few years into the business venture, they started to have a falling out. For the good of the business, they decided that the defendant should take control of the day-to-day decisions. They also signed an owners' agreement limiting the transfer of shares in AriZona to a designated class of transferees.

Two prominent suitors: At one time or another, two industry giants expressed an interest in acquiring part or all of AriZona. One was Tata, a global conglomerate and the second largest tea manufacturer in the world. In 2005, Tata estimated AriZona might be worth as much as $4.5 billion, and it came up with similar estimates over the next 10 years. But Tata never performed due diligence on AriZona and never obtained board approval for pursuing an acquisition.

The other suitor was Nestlé. In July 2010, it expressed interest in buying the plaintiff's 50% interest for $1.3 billion conditioned on Nestlé's ability to conduct due diligence, to eventually acquire the defendant's shares, and to reach an agreement with both partners to control the company. After the plaintiff rejected the proposal, Nestlé increased the offer to $1.45 billion. Ultimately, discussions foundered. Nestlé's board of directors never authorized any acquisition of AriZona. Nestlé said it was unable to obtain "good financial data" from AriZona.

A few months later, the plaintiff, frustrated by the transfer restriction in the owners' agreement and the failed attempts to sell his shares, sued for the dissolution of the company. In return, the defendant decided to pursue a buyout. The court's valuation of the plaintiff's 50% interest drew on elements from both sides. No expert's analysis was the clear winner.

As to the valuation method, both sides agreed to use a discounted cash flow (DCF) analysis and rejected the net asset value (NAV) approach. But the plaintiff's experts also advocated in favor of using a comparable transaction analysis, albeit weighting the resulting value at only 20% and assigning the remaining 80% to the DCF value.

The defendant objected that the proposed comparables were not sufficiently similar in size, timing, and products and were "synergistic market transactions" that the controlling case law did not recognize. The court agreed. AriZona, it said, was "truly *sui generis*, and thus any attempts to find comparable companies are truly lacking." Also, the expressions of interest from Tata or Nestlé were unreliable indicators of the value of AriZona. Neither company had access to audited financials or was able to do due diligence, and neither company's board of directors had approved an acquisition. The only method resulting in a reliable value calculation was the DCF, the court decided.

Liquidity risk? The parties' experts differed on a number of DCF components, including DLOM. The defendant's expert proposed a 35% rate. The owners' agreement was proof that the partners could not easily liquidate their shares. The plaintiff's expert maintained there was no justification for a DLOM. The company had been successful and major companies had expressed an interest in buying part or all of it.

The court sided with the defendant. It quickly distinguished this case from *Zelouf,* in which the court ruled against the use of a DLOM since there was no real liquidity risk because the business at issue probably would never be for sale. The liquidity risk in this case was real, the court said. The stalled Nestlé negotiations exemplified the plaintiff's difficulty of liquidating his shares. At the same time, the defendant's own expert, a recognized authority on valuations, allowed that "smaller discounts are often appropriate for large and growing companies." This described AriZona, the court said, reducing the DLOM to 25%. The court's "back of the envelope" calculation suggested AriZona was worth about $2 billion on the valuation date.

Takeaway: Expressions of interest in a company are not *bona fide* offers and, by extension, are not reliable indicators of value. Also, New York courts continue to find a rationale for applying a DLOM in fair value proceedings despite the questions the recent *Zelouf* decision raised about the theoretical underpinnings of DLOM.

Cap Rates Down in Senior Healthcare Market

Capitalization rates have decreased significantly for each segment of the senior care M&A market since 2013, according to recent data in *The 2014 Senior Care Acquisition Report*, published by Irving Levin Associates.

Bull market: For the four quarters ended Sept. 30, 2014, assisted living cap rates were down 70 basis points, from 8.7% to 8.0%. They were down 60 basis points, from 8.5% to 7.9%, for independent/assisted living. Also, they were down 70 basis points, from 13.0% to 12.3%, for skilled nursing.

"The availability of equity and cheap debt, plus an influx of new buyers, has been driving prices up and cap rates down in a seniors housing bull market that is seeing more M&A transactions than ever before," says the report. The average price per unit for assisted living facilities is up 30.5%, from $150,600 to $196,600; 28.8%, from $164,000 to $211,300 per unit, for independent/assisted living; and 7.0%, from $73,300 to $78,400 per bed, for skilled nursing.

10 Reminders for a Successful Divorce Valuation

Business valuations prepared for divorce purposes are much more challenging than valuations done for other purposes. That's because the rules differ among jurisdictions. There are no clear valuation guidelines for divorce in most states. For example, there's no specific definition of value in state statutes governing divorce. Also, divorce courts exercise a great deal of discretion—even if there is an abundance of judicial precedent (which can be confusing and contradictory).

Regardless of this complex landscape, there are some universal tips for valuation experts who do divorce work—pieces of advice that apply no matter the jurisdiction.

1. Realize that it is a litigation. The very first thing to realize in doing a valuation for divorce is that it is a litigation. How many times have you heard of an amicable divorce? Virtually all are contentious, some more than others. This is why, even though divorce cases may be a small percentage of the typical valuation practice, they account for a high percentage of the times valuation experts are called to testify as an expert witness. The valuation expert has to conduct himself or herself accordingly, understanding that what you say and what you do are subject to challenge.

2. Nail down the valuation date. Very early in the process, get a clear answer to the issue of the valuation date. This is a fundamental aspect to understand upfront. It could be the trial date, the complaint date, or the date of the divorce or separation. Most often you're dealing with an attorney (two attorneys if mutually agreed to or appointed by the court). Ask them to set the stage in terms of the valuation date—there could be multiple valuation dates as well.

3. Know the relevant valuation standard. Because the standard of value for divorce differs by jurisdiction, you need a complete understanding of the appropriate standard to use. It changes by state and sometimes within a state (and even within counties in states). However, while it is your responsibility to understand what the appropriate standards of value are, it's not your responsibility to choose the right one. That's something that should be agreed to between you and the client. Include it in your retainer letter. Because there is sometimes confusion as to the precise meaning of terms, make sure that everyone understands what the labels "fair market value," "investment value," and "intrinsic value" mean.

It is not up to the valuation analyst to make the law but to follow it. If the standard of value is clearly entrenched in the jurisdiction, the valuation expert should follow that standard. Otherwise, you will run afoul of the law. If the standards are vague, you should advise the attorneys on the vagueness of the standard and ask their advice on what to do about it.

4. Read prior case law very carefully. Rules for divorce valuations vary not only from state to state, but also by counties within some states. Therefore, you have to read the prior case law very carefully. It's an area in which the case law is not well developed. There's no definitive case law in many states, and in many states the courts use "fair market value" when they really mean something else because the judges just find "fair market value" to be a convenient phrase. Also, family law courts treat discounts and premiums differently than courts in conventional valuation cases, so you need to study relevant case law in this regard.

Don't just read articles about cases, and don't listen to other people's comments about cases. Go back and read the actual cases in the area where your specific valuation is going to be heard. When you do this, you will see the courts and the litigants and the attorneys struggling with the same kinds of issues that you will have to deal with. Each case has a lot of moving parts, and each individual situation is very specific in its facts and circumstances. It also needs to be looked at in the context of the rest of the situation that the parties are going through in their divorce, such as support.

5. Develop questions for both spouses. In addition to questioning the attorneys early on, you need to ask questions of the titled spouse and/or the outside spouse (depending on which one is your client and what kind of access you have). If you are mutually agreed to or court-appointed, you can expect to speak with both parties. Sometimes it's informal and sometimes more formal, through depositions or interrogatories through the attorneys.

From the titled spouse, your questions should be designed to collect information about the business, the type of entity, and the kind of business information that you'll need, such as financial information and qualitative and quantitative information. From the nontitled spouse, you should ask questions that explore that person's perspective and to raise any concerns or issues early on in the process so that you can address them as the case moves forward.

6. Get a list of entities involved. Ask for a list of the entities and the types of ownership of the entities, the ownership by the parties to the divorce, a brief description of the overall situation, and the number of companies involved. For instance, is the real estate owned by another entity that is leased to the subject company? While you may not be directly involved in valuing that real estate entity, you would want to make sure that you are consistent in terms of the lease payments and other aspects of the intercompany relationships between the real estate owner and the subject company that you may be valuing. Also, try to get a feel for whether other assets are out there that you need to know about for valuation purposes. If things get complicated, consider engaging a forensic accountant.

7. Memorialize key data. Put it in writing! This is one of the differences between valuations for divorce and valuations for other purposes. For example, if you have a telephone conversation, and when you get critical pieces of information, follow it up with a letter to confirm. When you send information requests to the attorneys, the litigants, and the business owners, ask for written responses (even if they say that what you want does not exist). Why bother with this? This is a litigation, so you need to cover yourself in case you are challenged in court.

8. Be prepared to teach. Because of the small amount of case law developed, divorce courts tend to be not as cognizant of business valuation theory and methodology as other courts. Divorce courts hear so many different issues that it limits the depth they consider when they have to deal with business valuations.

9. Carefully manage your time and cases. With a divorce valuation engagement, you're generally not in control of your own schedule. It's not unusual to get a call at the last minute about various deadlines or court appearances. This can be a big problem unless you manage your time and your cases appropriately.

10. Watch your fees. In divorce work, you're being paid by individuals, not company clients or law firms. And these individuals are shelling out a lot of money in connection with the divorce, so it often places an absolute ceiling on what can be charged. Sometimes you are working for the out spouse, and money is a problem. Many valuation experts will not take a divorce case without a retainer and an arrangement to be paid monthly. It's uncommon to charge above and beyond the retainer because the client views the valuation expert as a necessary evil and once the report is delivered or you have testified in court, the client has no use for you, so payment could become a very serious problem.

Final thought: There are other issues you'll encounter in a divorce engagement, including buysell agreements, non-compete covenants, goodwill, and the double dip. Therefore, you should be fully versed on these issues. Also, the lack of objectivity appears to be more prevalent in family law matters than in other types of cases. Therefore, the valuation expert must take extra care to avoid any pressure toward bias in favor of the client.

Economic Update at a Glance

U.S. economic growth continued in the third quarter and exceeded economists' forecasts, as GDP rose at a rate of 3.5%. Further, the second-quarter GDP rate was revised upwards to 4.6%. Consumer spending and business investment rose in the third quarter, though at a decelerating rate from the prior quarter. Government spending accelerated sharply, particularly defense spending, and imports declined. Final sales (GDP with inventory changes removed) grew more quickly than overall GDP, at a rate of 4.2% in the third quarter, matching its best performance since 2006.

The combined GDP growth of the second and third quarters made for the best six-month growth in the U.S. economy in over a decade. In addition, GDP growth in the third quarter of 2014 marked the fourth quarter out of five that the economy has expanded at or above a 3.5% rate. The Economic Policy Institute attributed some of the impressive six-month GDP growth to the fact that the economy rebounded after contracting in the first quarter of 2014. The Economic Policy Institute pointed out that the average growth rate is only 2.0% for the first three quarters of 2014, which it finds in line with previous recovery years. As a result, it believes that it is still too early to declare that the recovery has shifted into high gear and that it would be premature for policymakers—particularly the Federal Reserve—to ratchet down support for a full recovery.

Several large news outlets, including Bloomberg, Thomson Reuters, and *The Wall Street Journal*, all commented that much of the third-quarter GDP growth came from increased government spending and a shrinking trade deficit, while consumer spending, which has driven much of the economic recovery, decelerated. Some outlets noted that a couple of items benefiting growth in the third quarter were unlikely to be consistently repeated, namely heavy defense spending and a decline in imports, causing them to doubt whether growth could be sustained. Others pointed out that declining gas prices and accelerating job growth, which may lift wages, could prove to be tailwinds for consumer spending in the fourth quarter.

The Federal Reserve further tapered its bond-buying program in the third quarter, finding that the economy continued to have a sufficient level of underlying strength to support ongoing improvements in labor market conditions. If the information received at its next meeting supports the expectation of improved labor market conditions and inflation returning toward its longer-run objective, the Federal Reserve stated that it will end its current program of asset purchases.

The Federal Reserve continued to keep its target for the federal funds rate near zero, as it kept an eye on the labor market and inflation. The Federal Reserve went on to state that it likely will be appropriate to keep its target for the federal funds rate near zero for a "considerable time" after the asset purchase program ends.

The Federal Reserve's *Beige Book*, a summary of economic conditions in each of its 12 regional districts, stated the U.S. economy grew at a "modest to moderate" pace from mid-August through September. The report found that growth was moderate in the Midwest and West districts, but more modest in the South and Northeast. The *Beige Book* also noted that consumer spending had been "slight to moderate," though most districts were optimistic about their growth prospects because they expect a pickup in retail sales over the coming months. The report also noted that, generally, nonfinancial services strengthened and manufacturing activity increased, but residential construction and real estate remained mixed. Improvements in the labor market continued at the same pace as they had in the previous report.

The Conference Board reported that the Leading Economic Index continued its upward trend in September and signaled that the U.S. economy will continue expanding into 2015. Nine of the 10 leading indicators advanced in September. The Leading Economic Index has now increased in 12 of the last 14 months.

The Consumer Price Index rose in September, as rising food prices offset declining energy costs. The Producer Price Index edged down in September, as both the index for final demand services and the index for final demand goods declined.

Total retail sales fell in September for the first time since January, when severe winter weather kept shoppers at home. Sales were weak across most segments including clothing stores, auto dealers, building supply stores, and furniture stores. The core retail sales figure—which excludes volatile automobile and gasoline sales—also declined, albeit less than total retail sales. Despite the September decline, retail sales continue to trend upward.

The pace of job creation accelerated sharply in September, and job gains in July and August were revised upwards. The unemployment rate declined to 5.9% in September, its lowest figure since March 2008. Average hourly earnings for private-sector workers ticked down slightly, while the average workweek edged up.

After hitting a near seven-year high in August, the Conference Board's Consumer Confidence Index retreated in September. The survey found that consumers were less optimistic about the outlook for the economy and labor market conditions.

The Thomson Reuters/University of Michigan's Index of Consumer Sentiment rose in September to its second highest level in seven years. Consumers reported believing that the economy has improved and will continue to improve over the next year.

The National Federation of Independent Business reported that the Small Business Optimism Index edged down in September. The two components that fell the most drastically were the components for job openings and for planned capital outlays.

The 3Q 2014 Wells Fargo/Gallup Small Business Index rose to its highest level in more than six years. Business owners' assessment of their current conditions was the main contributor to the rise. The survey found that more business owners felt better about their current financial condition and reported that their company's revenues have increased, cash flow over the past 12 months was at a six-year high, and the ability to obtain credit over the past 12 months improved significantly.

Large-cap indexes had modest gains in the third quarter, but the midcap and small-cap indexes fell, with the Russell 2000 moving into negative territory for its year-to-date return. August was the standout month this quarter, and sell-offs occurred in July and September. Performance across the S&P 500 sectors varied.

The Institute for Supply Management's manufacturing sector index declined in September after last month's reading put the index at its highest level since March 2011. Regardless, the data indicated that the manufacturing sector expanded for the 16th consecutive month and the overall economy has now grown for the 64th consecutive month. The Institute for Supply Management noted that, based on the historical relationship between its manufacturing index and GDP, if the September index reading were annualized, it would correspond to a 4.0% increase in real GDP annually.

The Institute for Supply Management's index for the services sector slipped in September, after August's reading put the index at its highest level since its inception in January 2008. Despite the September retreat, respondents to the survey indicated that they remain optimistic about business conditions and the overall direction of the economy. The September index reading indicated that the services sector has now grown for the 56th consecutive month.

The Federal Reserve reported that industrial production rose 1.0% in September, its largest gain since November 2012, and was up 4.3% from one year ago. The manufacturing output of durable goods and nondurable goods rose, as did the output of utilities and mines. Capacity utilization advanced in September and was 1.0 percentage point above its level from a year ago.

The National Association of Realtors reported that existing-home sales rebounded in September, after dipping in August, to their highest level thus far in

2014. Despite this, sales are still below their level from one year ago. Home price appreciation continues upward, though the increases have moderated.

Housing starts and building permits authorized rose in September and remain above their levels from one year ago. Total spending on both private construction and public construction during the first nine months of 2014 was above the amount spent during the same period in 2013.

The National Association of Home Builders/Wells Fargo Housing Market Index continued to advance in September and remained at a level indicating that more builders view sales conditions as good, rather than poor. The report found that a strengthening job market and pent-up demand for new homes have contributed to a gradual, upward trend in builder confidence.

The National Association of Realtors' Realtors Confidence Index for current conditions fell in September, with realtors believing that the market for single-family homes dropped from "strong to moderate" down to "moderate," and townhouses and condos continued to be viewed as "weak."

Note: This newsletter does not constitute legal, valuation, tax or any other type of consulting advice. It is offered as an information service to our clients and friends. For specific legal and accounting issues, it is advisable to seek professional advice. We welcome the opportunity to discuss any specific valuation issues that you may have.

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